Maximizing Georgia's Agricultural Exports

Stimulating Economic Productivity in Georgia

December 10, 2004

Discussion Paper

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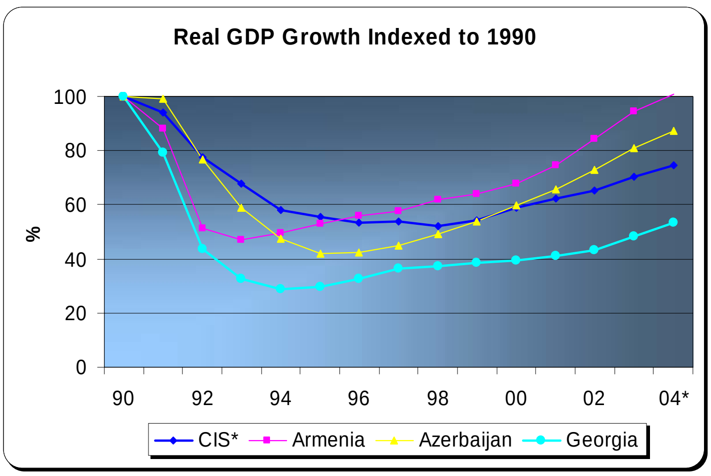
Introduction

This paper presents some of the options available to improve Georgia's economic productivity, particularly in the financial, agricultural and industrial sectors. Potential activities target USAID/Caucasus's strategic objective (SO) 1.31 (Accelerated Development and Growth of Private Enterprises to Create Jobs) and intermediate results (IR) 1.31.2 (Increased Access to Financial Services). The data presented is offered as an overview of Georgia's current economic landscape and in particular, of the financial sector, but is not intended as a comprehensive study or analysis.

Numerous reports, assessments, and studies commissioned by USAID (and others) over the last eight years have noted that accessing credit in Georgia is a major constraint for the development of small and medium sized enterprises and the agricultural sector (see Annex A for a complete list of reference material). The lack of access to credit is limiting Georgia's ability to acquire modern equipment and technology in all sectors and subsequently constrains productivity and economic growth.

Georgia's economy suffered a serious blow with the breakup of the Soviet Union. Export markets were lost, infrastructure deteriorated, and civil conflicts worsened the situation. In the mid-1990s a series of structural reforms were implemented including: legal, tax and regulatory reform, price and trade liberalization, and freeing the exchange rate. These programs had a stabilizing and positive result, but Georgia's recovery continues to trail behind other CIS countries.

The lack of access to credit, particularly long-term financing (3-5 years) has further contributed to Georgia's mediocre economic recovery. In the agricultural sector for example, since its independence, Georgia has seen a large decline of agricultural exports, and an increase of imported products that Georgia previously produced (eggs, milk, and chicken, for example). In addition, continued high unemployment rates, the visibly outdated technology, and the poor condition of manufacturing, processing, and production equipment is further evidence of the constrained productivity due to the scarcity of capital.



Two of the most significant components that are used to measure economies and their performance are GDP and employment. Georgia's real gross domestic product (GDP) growth rate reached double digits (11.6%) in 2003, the first time in five years. By comparison, however, Georgia's GDP growth (indexed to 1990 - Georgia's independence) has lagged far behind (by approximately 50%) other CIS countries and in particular other Caucasian countries. The single largest contributor to Georgia's GDP is agriculture, which contributes 19.2%.

But, the total value of the agricultural sector output has shown a steady decline since 1998, down 18.9%. The second largest contributor to Georgia's GDP is industry, which contributes 17.6%. Industry however, has shown zero growth, as a percentage of GDP, over the past 5 years. In other words, the agricultural and industry sectors together contribute nearly 37% of total GDP production but both are experiencing negative or zero growth.

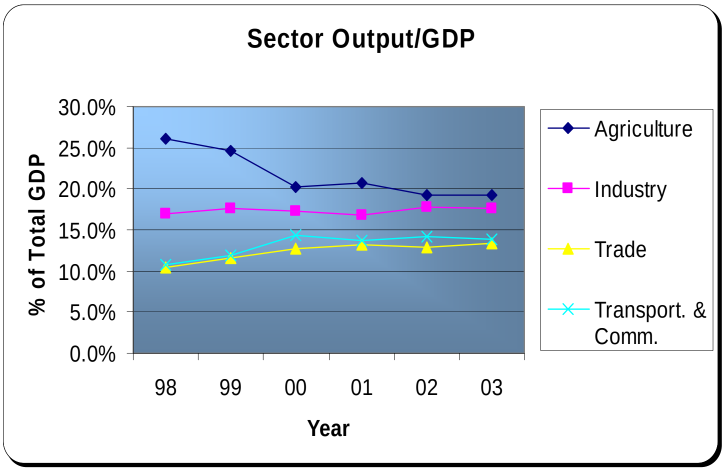


Table 1

Sector: % of Total GDP	98	99	00	01	02	03
Agriculture, Forestry, Fishing	26.2	24.6	20.2	20.7	19.2	19.2
Industry	17.1	17.6	17.4	16.7	17.6	17.6
Sector: GDP Output (million USD)						
Agriculture, Forestry, Fishing	$946.3	$699.2	$616.2	$662.3	$653.8	$767.6
Industry	$616.4	$498.5	$528.7	$535.4	$599.8	$704.2

Source: State Department of Statistics

Employment is a very important factor for any economy. The more the country is working, the healthier the economy. The unemployment statistics are not reliable in Georgia, but if we look at the sectors by number of people employed, we see that the agricultural sector alone accounts for 55.6% of all employment and the industrial sector utilizes 6.2% of total employment. Together these sectors account for over 61% of all employment in Georgia.

Table 2

Sector: % of Total Employment	98	99	00	01	02	03
Agriculture, Forestry, Fishing	57.5	58.1	57.7	58.0	54.4	55.6
Industry	5.6	6.4	6.9	6.2	6.4	6.2
Sector: Employment (Thousands)						
Agriculture, Forestry, Fishing	1,226.6	1,191.9	1,233.2	1,225.0	1,054.8	1,225.9
Industry	120.4	132.2	147.5	131.6	124.0	137.0

Source: State Department of Statistics

Given that the agricultural and industrial sectors contribute 37% of Georgia's GDP and account for over 61% of all employment, it is logical that donor stimulated assistance would focus on helping these two sectors regain lost capacity. Both of these sectors need access to long term credit in order to be healthy, productive, and to grow the economy. Strangely, as we will see below, the agricultural sector only receives 1% of the total bank loans. Creating access to long-term credit will stimulate the agricultural and industrial sectors that are currently not being served by the banking sector. This lack of financing is one of the major constraints to turning around the decline of the agricultural sector and to increasing industrial output. Creating access to long-term financing for these sectors will stimulate private sector investment, increase value-added production, and improve technology and Georgian competitiveness.

Development of Banking in Transitional Economies

In a transitional economy as a banking sector develops, the first type of loan investments are short term. This is primarily because loans for 30 days are less risky than long-term loans, i.e. 3 years. In addition, banks utilize an abundance of collateral to secure loans in the developing years; item such as cash, gold, or other highly liquid assets.

As banking develops further and with increased competition, several conditions evolve. Interest rates begin to decline, loans are extended for longer periods, leasing enters the market, and sectors previously avoided gain access to credit (again, first short term and then longer term). Collateral follows a similar evolution beginning with high collateral requirements that are highly liquid. Then mortgage secured loans develop because of the immovable nature (also used as an abundance of collateral) of real property. The development of using moveable asset to secure loans depends on the confidence in the movable asset registry and court system. Accounts receivable and inventory as a sole source of collateral is developed in the later stages of the sector's evolution.

Georgia's banking sector development is following these general trends and is at the beginning stage of extending longer-term loans. Since USAID-Caucasus' SME Finance Program ("CSFP") introduced a mortgage-lending program in 2001[1], virtually all of the long term lending in Georgia is now in the real estate sector. In addition, interest rates have shown a steady decline over the past three years; down from over 20% to 13%, and the Georgian banking sector has expanded its lending activity to include micro and rural borrowers (supported by donor credit lines), a sector they previously avoided. Georgia is well-positioned to begin delivering long term credit to the sectors who are most in need and who provide the largest contributions to both the country's GDP and employment rosters (agriculture and industry).

The Georgian Financial Sector

Leasing

The leasing business in Georgia is new, but growing. There are currently two leasing companies, TBC Leasing and Georgia Leasing Company (GLC). TBC leasing is 100% owned by TBC Bank and GLC is 60% owned by Tbiluniversal Bank (soon to become Bank of Georgia). The leasing companies' combined portfolios, as of September 2004, exceed $2

[1] Mortgage lending was initiated in Georgia through the USAID-Caucasus SME Finance Program ("CSFP").

million, whereas the demand for leasing in 2004 was assessed in excess of $20 million[2]. Granting long-term financing on equipment for the leasing companies is not a problem; in fact it is their specialty. Leasing provides financing for three to five years and the current weighted average to the lease portfolios is 35 months. The primary problem for the leasing companies is that they have limited funds (cash) to purchase equipment for lease. Unlike the banks, the leasing companies do not take deposits. They must raise their capital through a combination of debt and equity.

Banks

The banking sector has been consolidating since 1995 when there were more than 100 banks in Georgia. As of September 30, 2004, there are 22 banks in operation; 20 Georgian banks and 2 branches of foreign banks). This is compared to 24 banks at the end of 2003 and 27 banks in 2002. The consolidation process is in part due to the increase of banking capital requirements by the National Bank and by strategic acquisitions. In fact, the Bank of Georgia just announced the purchase of Tbiluniversal bank effective January 2005. This merger will move Bank of Georgia within 2.2% of TBC bank who holds the lead position of 22.9% of total sector assets.

As of December 2004, the capital requirements for banks will increase to GEL 6.4 million and step up year by year until December 2008 when it reaches GEL 12 million. Currently, 8 of the 22 banks meet the new GEL 12 million requirements. However, there are 6 banks that do not meet the GEL 6.4 million requirements that are effective December 31, 2004. The result of further consolidation will be a stronger banking sector.

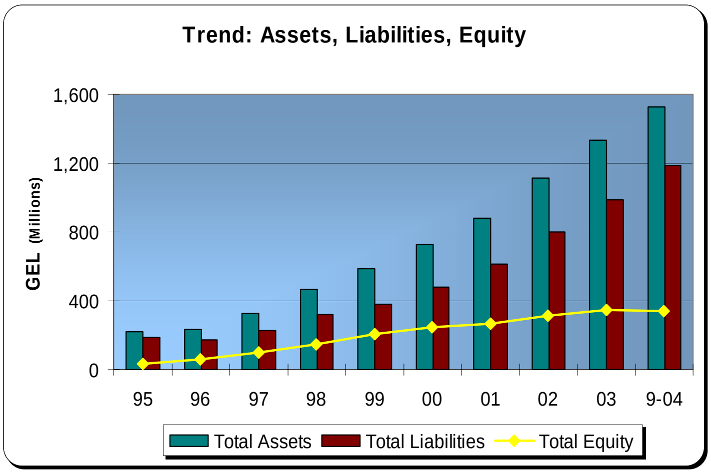
The top five (5) banks of the country, ranked by total assets, represent 73% of the total banking sector. This will increase to over 75% with the merger of Tbiluniversal (ranked number 9) and Bank of Georgia. The top two banks were rated CCC+ by Fitch Rating as of year end 2003. This rating reflects the high country risks, low loan loss provisions, and the volatile operating environment. As of September 30, 2004, the top five banks, ranked according to total assets were as follows.

Table 3

1	TBC Bank	22.9%
2	Bank of Georgia	18.2%
3	United Georgian Bank	11.0%
4	Cartu Bank	10.6%
5	Procredit Bank	10.5%
	Total	**73.2%**

Source: National Bank of Georgia

[2] AgVANTAGE leasing component supplemental information to first annual workplan: "Assessment of the Market Potential for Leasing in Georgia", February 20, 2004. IFC, "Potential Lease market In Georgia – Survey Analysis", April 2004.



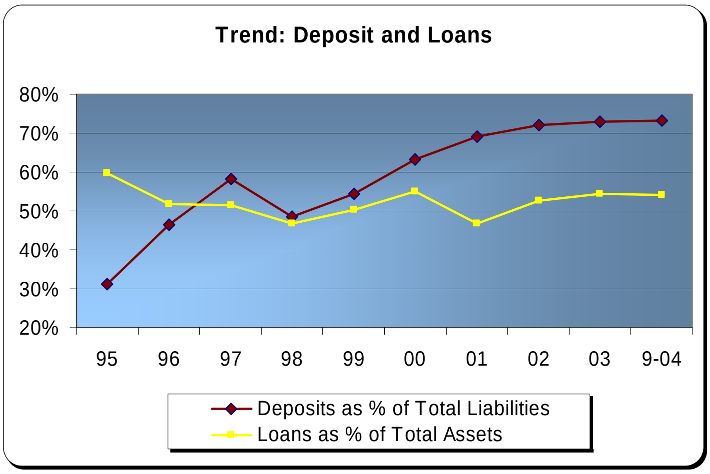
The banking sector continues to show strong growth. Total assets grew 19.5% in 2003, down from 26.8% growth the previous year (although there were three fewer banks). As of September 30, 2004, assets are up 14.4% over 2003. Capitalization of the banking sector also improved with total equity growing to GEL 337 million ($187 million), up 10.1% over 2003.

The quality of loan assets is also showing signs of improvements. Non-performing loans are 5.7% of the total loan portfolio or GEL 50 million ($27 million), compared to 8.5% in December 2002[3].

Deposits

Regardless of how they are compared, total deposits demonstrate a steady growth. In monetary terms, deposits have increased over each of the past 5 years and in relation to total liabilities, deposits are up from 30% in 1995 to 73% in September 2004. The steady level of deposit growth demonstrates a continued confidence in the banking sector by the depositing public.

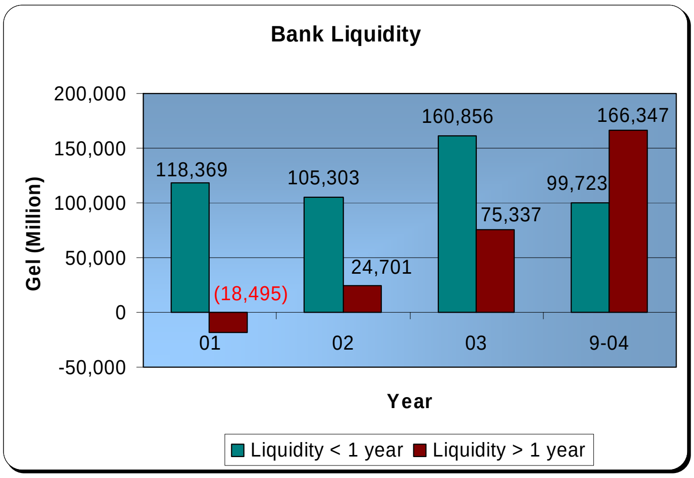
Deposits for banks are a source of funds to mobilize investments (i.e. loans). Although deposits have steadily increased, total loans as a percentage of total assets have remained relatively flat at approximately 54%. Looking further into the structure of the consolidated balance sheet of the banking sector, we find that banks have used this increase in deposits to reduce their borrowings from other sources (primarily credit lines with donor organizations); down from 35% of total liabilities in 1999 to 21% in September 2004.



It is important to understand that banks must match the maturities of loans with the source of funding (i.e. short term loans funded by short term deposits). It is risky for banks to use short-term deposits (i.e. demand accounts) for long-term loans. Banks must maintain a proper liquidity to meet the depositors demand for withdrawal of funds and cover other obligations as they come due.

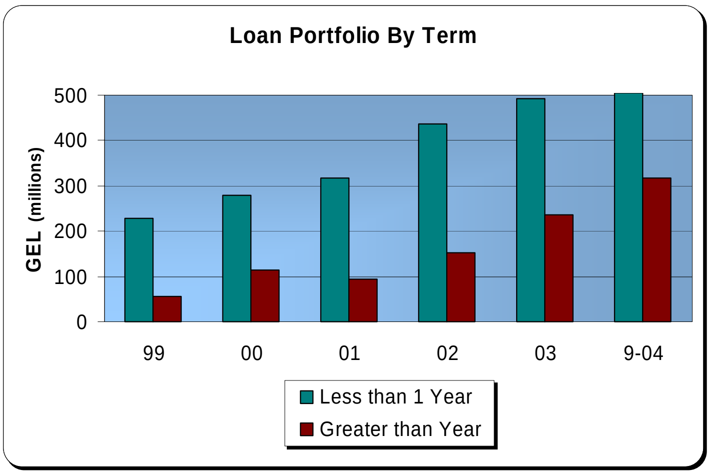
[3] World Bank Policy and Institutional Review, November 2004

The liquidity of the banking sector has continued to rise, adding strength to the sector. A further analysis, matching maturities of short-term deposits to short term loans (less than one year) and long-term deposits to long-term loans (greater than one year), shows that the banks have an increased capacity to take on longer-term loans. As of September 30, 2004, the banking sector showed over GEL 166 million or approximately $92 million of liquidity (matched long-term maturity). A portion of this liquidity could be used to significantly increase their loan portfolios.



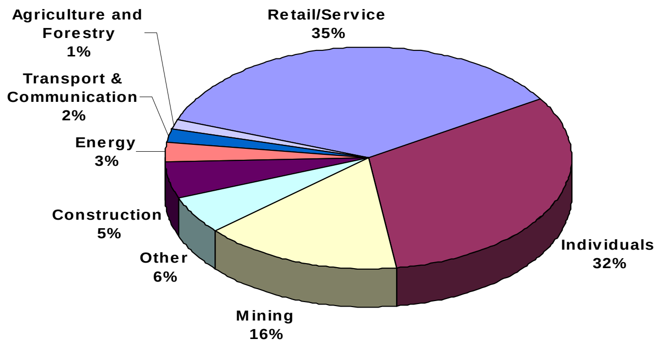
Loans

Loans greater than one year have grown from 18.8% of the total loans outstanding to 38.6% since 1999. This increase is mostly fueled by mortgage lending, which began in 2001. Loans secured by real estate now total approximately GEL 284 million. Considering that loans secured by mortgages are typically long-term, practically all of the increase in long-term loans is mortgage related. In order for Georgia to increase productivity, long-term financing is also needed for equipment.



The industry sector breakdown of loans by the National Bank does not mirror the industry breakdown by the State Department of Statistics. The only category that is consistent is agriculture. Agriculture represents 1% of the total banking sectors loan portfolio, yet as we saw above the agricultural sector represents nearly 20% of GDP and employees more than 57% of the population. The two sectors that receive the most credit are retail/service and individual, totaling 67% of all loans.

Loan Portfolio by Sector - September 2004



High Demand, Low Service

The following describes, by use of simple economic comparisons, the fact that there is a high demand for long-term credit and yet the banking sector is not serving this market. The total size of the Georgian banking sector is small, GEL 1.524 billion or approximately $850 million US dollars. Georgia's banking sector total assets as a percentage of GDP are 15.7% as of December 31, 2003, which is very small. This ratio is used to demonstrate the level of financial services provided by banks relative to the size of the economy. Georgia is slightly behind the average CIS-7, but half the contribution compared to the other CIS countries (see table four, Bank Assets/GDP).

Furthermore, the South Eastern Europe banking sector provides 45.5% and Central and Eastern Europe and the Baltic States, 74.4% relative to the size of their economies.

Table 4

	Bank Assets/GDP		Deposits / GDP		Loans / GDP	
	1995	**2002**	**1995**	**2002**	**1995**	**2002**
Georgia	6.4	15.0	1.7	7.7	3.8	7.9
CIS-7[1]	15.9	18.3	6.0	10.7	6.8	9.7
Other CIS[2]	16.2	29.5	9.6	15.9	5.8	15.8
SEE[3]	57.3	45.5	26.8	23.5	12.0	19.2
CEE+B[4]	53.1	74.4	34.4	47.9	25.6	31.4

Source: Bridging the "Great Divide", Nicolo,Geadah, Rozhkov

1. Armenia, Azerbaijan, Georgia, The Kyrgyz Republic, Moldova, Tajikistan, and Uzbekistan.
2. Belarus, Kazakhstan, Russia, Turkmenistan, and Ukraine.
3. South Eastern Europe: Albania, Bosnia and Herzegovina, Bulgaria, Federal Republic of Yugoslavia, Former Yugoslav Republic of Macedonia, and Romania.
4. Centeral and Eastern Europe and the Baltic States: Croatia, Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia, as well as Estonia, Latvia, and Lithuania.

Using the ratio of total loans in the banking sector to GDP (instead of total assets as above), the banking sector loans total only 8.6% relative to Georgia's GDP for 2003. Again, this is low. Table four provides a further comparison of bank deposits and loans to GDP as of 1995 and 2002, relative to other countries. Although there are increases over 1995 levels, Georgia remains far behind other related economies.

By way of another comparison, the Gross Domestic Investment (GDI) of a country's economy is the amount of fixed capital invested (i.e. plant, machinery, and equipment)[4], or long-term assets. These types of assets are generally financed with long-term credit. The International Finance Corporation (IFC) uses GDI to measure potential market demand for lease financing.

For example, in OECD economies, the leasing sector alone will normally finance between 20 and 30% of GDI. In Georgia, however, the loan portfolio growth of the entire banking sector in 2003 was only 6.6% of gross domestic investment in 2003.

Table 5

(in USD million)	98	99	00	01	02	03
Gross Domestic Investment (USD)	$755.7	$627.2	$659.9	$703.0	$755.1	$978.3
Increase of total loans in Georgia	$35.7	$38.1	$51.6	$5.5	$80.9	$64.3

Source: State Department of Statistics and National Bank of Georgia

In the fall of 2003, the IFC prepared a market survey on the demand for fixed assets (published April 2004). The response to their survey showed that this demand was at $383 million. Furthermore, businesses were asked to rate a list of impediments or obstacles to their business development. In order they were: unfavorable business climate, unfair competition, high taxes, and lack of credit/investment. Although the change in government has resulted in some positive changes in the first three areas, the "lack of credit/investment" is not currently being addressed.

What the aforementioned comparisons demonstrate is that the banking sector is very small relative to the size of the economy (in other words, there is room for tremendous growth) and that relative to GDI, the financing of capital investments is underserved. Private sector investments are commonly made through a combination of debt and equity (an efficient leverage of funds). Consequently, if access to long-term credit were more available in Georgia there would be greater capacity for increased capital investments and a higher contribution from the financial sector.

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[4] Gross domestic investment (also called Gross capital formation) consists of outlays on additions to the fixed assets of the economy plus net changes in the level of inventories. Fixed assets include land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. Inventories are stocks of goods held by firms to meet temporary or unexpected fluctuations in production or sales, and "work in progress." According to the 1993 SNA, net acquisitions of valuables are also considered capital formation.

Constraints to accessing long-term financing

Lending is an investment and investments are all about the comparison of alternatives and the assessment of risks -vs- return. Up until recently, the government was issuing treasury notes with yields in excess of 40%. Consequently, banks found treasuries more attractive than long-term loans yielding 16-20%. Treasury bills have since declined from the high levels, but still offer an attractive return on investment when comparing liquidity, the high transactional costs of long-term lending, and the short-term nature of the investment.

Different analytical techniques and lending practices are used to assess loan risks depending on the specialized nature of the industry. Agriculture lending, for example requires an understanding of needed farm inputs, costs, cropping cycles, cultivation practices, yields, post harvest handling, and market information for the sale of the final product (the banks source of loan repayment). The banks in Georgia have little knowledge about these specialized techniques. Consequently, the perception of risk for agricultural lending is high when comparing to other investments (i.e. treasury bills).

In addition to understanding the analytical techniques, agricultural lending requires the understanding and management of uncontrollable risks like weather: crop damage due to freezing, droughts, hail, floods, and winds. There are always risks in lending, but without knowledge about the industry, both farmers and lenders are unsure how to mitigate them.

Georgian farmers also lack farm financial management skills, accounting records, budgets, and financial statements, which when combined with the specialized lending techniques of the industry, become the tools needed to properly evaluate credit risks.

Transactional costs are a large burden for Georgian lenders. Agricultural borrowers live and farm in remote locations compared to major cities where banks tend to locate branch offices. When one considers distance and the required routine monitoring of business activities, the transactional cost for long-term loans is higher than other loan products. In addition to transactional costs, the bank overhead costs in Georgia are high. According to a recent World Bank review on the financial sector, overhead costs range between 14-18% of earning assets.

Available collateral and its market value is another constraint to accessing long-term financing. Lenders prefer liquid collateral that they can hold in their possession, such as cash or gold. Secondly, they like real estate assets because they don’t disappear. Liquid assets are not realistic for long-term financing for the purchase of equipment and most businesses do not own real estate. Utilizing moveable assets for collateral in Georgia is constrained by the lack of a functioning collateral registry and an efficient judicial system that enforces strong creditor’s rights. A new Public Registry Agency was recently established under the Ministry of Justice and a draft law on public registry has been presented to the Parliament. Unfortunately, the current draft law does not effectively address creditor’s rights, rules of priority, and enforcement.

Another constraint specific to leasing, is how the tax code treats those expenses that affect equipment financing (depreciation, VAT). AgVANTAGE is working hard to expand leasing in Georgia via the proposed tax code currently under consideration by the government. This legislation is vital to whether the leasing sector will have the opportunity to be a robust financing source or will remain as a secondary alternative to bank lending.

Synopsis

As seen above, the leasing sector is new but growing and leases are written for three-to-five year terms. The banking sector is consolidating, assets are growing, deposits are on the increase, and the sector is liquid. However, the banks perceive the rewards of short-term lending utilizing highly liquid assets and long-term loans utilizing real estate as collateral are greater than the risks of long-term lending to the agriculture or industrial sectors secured by equipment.

The agricultural and industrial sectors contribute significantly to Georgia's GDP, and they account for a substantial share of the country's employment, but they receive very little bank financing. In addition, although long-term loans are on the rise, this increase is due to mortgage lending, not equipment financing. In order to grow the economy, a combination of productive human resources and modern technology must come together. This can only happen when financing resources are available to acquire the equipment and employ the resources.

Georgia's increased economic productivity is the primary objective and whether that growth comes from an increase in job generation, an increase in private sector investment, an increase in value added production (industry and/or agriculture), or any combination of these, increasing access to credit can directly and positively impact these objectives.

Helping the Financial Sector to Increase Economic Productivity

Applying strategic development assistance via a range of funding mechanisms and programs can stimulate long-term financing for the underserved markets described above. The idea is to employ sustainable lending techniques, train both borrowers and lenders, creatively leverage funding by utilizing guarantee programs like DCA, GDA and/or financing programs like OPIC (for example), and/or target subsector investment so that Georgia's economic growth is not stalled or even derailed by the neglect of its two primary productive sectors. Interest rate subsidizes, equipment grants, cash grants to borrowers, or other similar support programs that could disrupt the free market of financial sector are not recommended.

The following discussion suggests a range of interventions that could be made by donors or investors via the financial sector (banks, leasing companies, and/or commercial finance corporations) for the stakeholders in the agricultural and industrial sectors. These interventions all address the fundamental question of how to stimulate economic productivity in Georgia.

Banks

As we have seen, the banks in Georgia are liquid, stable, and poised in their growth to undertake an expansion of their long-term loan portfolio to sectors beyond real estate secured loans. In addition, Georgian banks have extensive branch systems so implementing a long-term credit program would be straightforward. Branch networks are in place, ready pools of customers are present, and the bank operational systems already exist.

As demonstrated by the small percentage of loans to the agriculture and industrial sector, banks are risk averse to both sectors. Long-term bank financing although increasing is centered in mortgage type lending, not in productive assets (such as equipment) that have a different risk analysis and techniques for lending. In addition, banks do not see moveable assets (i.e. equipment) as "good" collateral. Financing support programs are needed to teach lenders how to assess and mitigate risks associated with long-term lending and the agriculture/industrial sectors. These programs must teach international best practices for lending to the agricultural and industrial sectors and could share lenders' risks while delivering long-term credit, and are viable options for moving the banking sector into the identified underserved markets.

Potential Interventions - Banks

USAID's Development Credit Authority (DCA) program could provide a viable alternative for expanding bank lending programs for long-term equipment financing to the underserved agricultural and industrial sectors. DCA provides guarantees, not loans, and so fundamental to the DCA program is the notion that the lender must have sufficient liquidity (the source of funds or money) to grant the loans. As noted above, the banking sector shows signs of excess liquidity available for long-term loans. DCA could help Georgian lenders extend long-term loans for productive equipment to underserved markets by providing a guarantee of up to 50% of the net losses incurred. Equally important with a credit guarantee program like DCA is the needed technical assistance to train borrowers on how to borrow, lenders on how to manage their transactional costs and assess agricultural loans, and work to improve the legal environment to further encourage long-term lending investments.

A new approach for stimulating long-term credit could be combined with developing the capital market. This concept uses, “on-lending”, (with strict international guidelines followed and best practices of long-term equipment financing implemented by an experienced lender), but introduces the market mechanism of securitizing the loans generated (a pool or portfolio) and the selling them in the capital market. This concept would allow Georgia to develop what is known as a secondary market for loans (financial instruments). This would create an additional source of investments and liquidity for banks. Funding would likely be needed from USAID or a combination of donors (although a DCA guarantee to a private sector investor(s) could also be considered).

In the development of capital markets, prospective borrowers could be sourced through participating banks (an outreach marketing component of a given intervention), but final credit analyses, loan terms, collateral requirements, documentation, and funding decisions would be made by the program implementers. Once a pool of loans was completed (for example $2 – $5 million), the portfolio would be securitized and sold (to the banks) to the highest bidder on the capital market. The sale of this portfolio (with or without loan servicing rights, which are very valuable) would then replenish the program’s funding and allow another round of loans to be generated, securitized, and sold. This activity could continue to revolve and has the potential to become sustainable with private sector capital. Regardless of any sustainability objectives, a number of other market enhancements will have been introduced to Georgia, in addition to the original objective of simply creating access to long-term financing equipment.

Leasing

AgVANTAGE is currently assisting the two leasing companies, TBC Leasing and Georgia Leasing Company (GLC), although the funding support is limited. Lease terms are currently being written for 3-5 years, so the primary problem for the leasing companies is that they have limited funds (cash) to purchase equipment for lease. Unlike the banks, the leasing companies do not take deposits. They must raise their capital through a combination of debt and equity.

One of the important contributions that the leasing sector makes to the growth of the economy is that it helps to create a secondary market for used equipment. This not only keeps Georgia competitive, but it provides used equipment to smaller producers who improve their production capacity product quality. Currently there is no secondary market for used equipment, but there is a great demand for equipment. Therefore, as equipment comes “off lease”, ready customers (small businesses) will be in line to either purchase this equipment (with a long-term loan) or to lease the equipment.

Potential Interventions - Leasing

Although the banks show excess liquidity they are unwilling to extend long-term equipment loans. The leasing companies have the opposite problem; they provide long-term financing on equipment, but lack sufficient capital to meet the market demands. An intervention by the DCA becomes viable for leasing only when an outside source of funds (private sector or an internationally strategic investor) is willing to make a capital investment (debt/equity).

One of the most widely used sources of financing for leasing is credit lines. In fact, OPIC approved a $1 million credit line for GLC, in September 2004. In developed markets, leasing companies will typically leverage their capital at 15:1 by way of bank borrowing (credit lines). In Georgia, 5:1 would be more realistic. Based on their current capital base approximately $10 million worth of new leases could be generated.

The AgVANTAGE leasing program is a working model of a type of credit line. The program currently provides funding support (co-financing or partial guarantees) to share risk on equipment leases to the agricultural sector. This program was developed as a support service for the production, processing, and marketing components of the AgVANTAGE project. The leasing program is funded with $500,000 and combined with the leverage of the leasing companies' capital it is projected to eventually provide $1 million in assistance. The direct financing impact of this program is restricted somewhat by its limited funding, but its portfolio provides the leasing companies with significant technology transfer and best practices concerning how to lease to the agriculture sector.

The AgVANTAGE leasing model (credit line) could be expanded in both amounts of funding and in terms of eligible customers (not just AgVANTAGE customers) who meet defined program goals (i.e. employment generation, new technology, expansion of private sector investment, etc.). Further expansion could involve teaching leasing to prospective borrowers. This model could also be replicated by means of a more traditional bank-financing program or through a commercial finance company, as discussed below. USAID support can be most effective through the AgVANTAGE model, one that ensures that long-term financing is made available to targeted sectors (agricultural or industrial).

Commercial Finance Corporation

A commercial finance corporation (CFC) is a private sector entity that is dedicated to providing financial services (loans, letters of credit, export financing) to commercial businesses. The development of a CFC would be a new concept for Georgia, but one that, given the size of the market, could be very effective. In most countries, CFCs target particular sectors such as agriculture and industry. Like leasing companies, CFCs do not take deposits and must raise their own capital through a combination of debt and equity. This would be a challenge for Georgia, but not unworkable. These companies develop expertise in industry sectors, the related equipment, and analysis for long-term equipment financing needs.

Potential Interventions – Commercial Finance Corporations

An innovative approach to starting a commercial finance corporation would be to take advantage of the banking sector's current trend toward consolidation. As noted above, there are several banks that may not be sustainable under the increased capital requirements set by the National Bank of Georgia. This could provide an opportunity to work with the National Bank to sell the deposits of one or more of these weak banks including the franchise value of any unneeded branches, and convert the operations to a CFC.

For example, Agro-business Bank has been for sale for over a year with no takers; although they have some donor ownership it appears that they are not willing to further increase their equity position. This bank could be an candidate for the donor community to convert to a CFC. The donor(s) would simply partner with the private sector, sell the deposits and the franchise value of unneeded branches, and provide the needed long-term credit, export financing, letters of credit, equipment financing and other financial services (including equipment-leasing activity) to the agricultural and industrial sectors.

Like with a leasing company, the capital for loans in a CFC is raised through a combination of debt and equity. USAID's DCA program for commercial finance companies would face the same concerns as it might with leasing since the DCA does not provide capital for lending only guarantees. Where DCA might be helpful is in the conversion of a bank to a commercial finance corporation. DCA could be considered to issue a guarantee to private sector investors (local or international) who capitalize the CFC or use guarantees for loans as discussed under bank interventions.

Credit lines are a logical option for providing needed capital to a CFC and are currently the most commonly used source for financing their operations. Like leasing companies, CFCs leverage their capital through bank borrowing and credit lines. With $2 million of capital for example, more than $10 million worth of loans could be generated in Georgia. With the use of a credit line for a CFC, there are no questions about funds being available to grant loans. The terms and conditions of credit lines are flexible and could be structured such that borrower criteria and customer profiles are well defined or such that credit risks could be shared (co-financing), which further leverages the capital and maximize program impact.

Lastly, an intervention like providing the equity investment to start a CFC could be a good alternative to helping convert an undercapitalized bank with a good branch network (like Agro-business Bank). It would require close coordination with the existing shareholders of the bank and the National Bank of Georgia, who might appreciate such an alternative.

Targeted Sub-sector Development

Although there are many agricultural and industrial subsectors that are in need of investment, it is important to focus on those that 1) return the most for the investment, and 2) provide the greatest development impact.

The approach would be to identify a specific sub-sector and act as a facilitator to develop an investment bulletin (strategy) and then market and seek appropriate investment to implement the identified activity.

For example, the poultry sector in Georgia produces approximately 13,000 tons of chicken meat (broilers) per year. However, the consumption of broilers is approximately 38,000 tons per year. This means that 25,000 tons of chicken meat are imported per year that Georgia could otherwise produce. These imports represent approximately $80 million of added value production that is currently going to other countries. To capture this loss, a strategic assessment and investors bulletin needs to be completed. The two primary bottlenecks for broiler production in Georgia are good genetic stock and a proper processing line(s). The cost of a processing line ranges from between $200,000 to $300,000.

The broiler sub-sector is an example of where investment intervention can make a big difference. Other sub-sectors similar to broilers include eggs (roughly 35% of all eggs consumed in Georgia are imported) and milk (60% of all packaged milk is prepared from powered milk and then mixed with fresh milk - 40%). With some strategic capital investment, this sub-sector could significantly decrease the importation of powered milk (increasing the quality of its milk product as well). The broilers, eggs, and milk subsectors are only presented to help describe the concepts presented. AgVANTAGE has identified a number of strategic investments that could deepen project impact.

By focusing on and supporting import substitution (the replacement of goods currently being imported that Georgia could produce), job creation, value added production, and an improved product quality would all be gained.

In addition to the market chain development that is the focus of the AgVANTAGE program, current staff expertise in international finance and business could be accessed to further assist the development of targeted subsectors (like those mentioned above). AgVANTAGE staff is providing strategic development (capacity building) to support the types of import substitution activities and market chain investments that these subsectors require in order to grow. However, with the projects experience to date, this area is in greater need than the current capacity of the project. Project activity could be further expanded to identify, research, market, and implement targeted “investment opportunities”, where AgVANTAGE would act as a facilitator, to find seek investors for strategic agricultural subsectors. These targeted subsectors’ activities could be further assisted through private-public partnerships under USAID’s GDA program. This program would further support the Government of Georgia’s investment activity under the Ministry of Economy.

Export financing

AgVANTAGE has experienced on several occasions the limited ability of the banking sector to provide export financing to the agricultural sector. While it is true that the Georgian banks are good at trade financing (the majority of their loan portfolios), they are risk adverse to the agricultural sector.

One case in point is a current AgVANTAGE customer who grows, buys, and brokers mandarins. Last year this customer collected and sold 120 tons of mandarins with his own funds. This year, the customer, with AgVANTAGE’s assistance found additional buyers and an additional 700 tons of mandarins. The customer could finance 320 tons from his own resources, but needed export financing for 380 tons. The amount of export financing needed was up to $240,000. Because he was a customer of ProCredit Bank he approached them and was approved for a $150,000, 4-month line of credit. The loan was secured by a commercial ship valued at (Euro) 280,000. The bank's willingness to extend the credit was partially due to the involvement of AgVANTAGE, but primarily on the reliance of the security (the craft), not the export crop or the receivable as is customary in such financing. The wholesale value of the product was $420,000 and the value of the accounts receivable from the known buyers was $630,000. These normal sources of collateral were not considered.

In order for AgVANTAGE to mitigate the identified constraints, sources of export financing support are needed to facilitate and support these types of transactions with a variety of agricultural products (mandarins, potatoes, onions, etc.).

In further support of export financing (and farm operating lines of credit) consideration should be given to developing crop insurance in Georgia. This insurance is practical for both growing crops and the insurance of finished product being shipped to market. The insurance industry in Georgia is very small, but growing. It is currently not a product offered, but could be further developed, potentially with the support of DCA.

Conclusion

The fundamental conclusion of this paper is that the Georgian financial sector is poised to receive the level of assistance that will make it possible for them to provide long-term credit to the agricultural and industrial sectors, the two most important productive sectors in Georgia's economy. In an effort not to miss the opportunity to grow Georgia's economic productivity, this paper provides a wide range of suggested or possible interventions to further discuss and be explored in greater detail.

ANNEX A

In addition to AgVANTAGE's own market experience and analysis, the following reports provided further support the lack of access to credit, the need for long-term financing and that leasing is a viable alternative for long-term financing in Georgia.

- USAID/Caucasus – Georgia. Country Strategy 2004 – 2008, August 2003.
- USAID/Caucasus – Georgia, Office of Economic Reform. Georgia Agricultural/Agribusiness Sector Assessment, Heron, Lee & Winter, March 2001.
- IFC Study. Equipment Leasing in Georgia, Carter, Cuming, & Tumu, 1997.
- UMCOR/CAP. Agricultural Machinery Availability and Usage Survey in Eight Selected Communities of Western Georgia, Gvetadze, Wesch, November 2001.
- USAID/SAVE-ACDI/VOCA. Assessments of Specific Constraints to Agribusiness in Georgia and Methodology for Prioritization, Phase I Report, 2002.
- World Bank. An Update of Agricultural Developments, July, 2000.
- USAID/DAI. Regional Credit Evaluation Project in Georgia, October 2001.
- USAID/DAI. PWC. Small and Medium Enterprise Development in Georgia: Assessment and Recommendations of USAID's Strategy, May 1999.
- IMF. Georgia: Selected Issues and Statistical Appendix, November 2003.
- USAID/Caucasus – Georgia, Office of Economic Reform. Georgia Market Reform And Agriculture Assessment, Brown, Coles, Heron, Sprout, Winter, September 2000.
- Conference: Access to Land. Sustainable Rural Development and Poverty Reduction in Georgia, Didebulidze, Bonn, March 2001.
- USAID/SAVE-ACDI/VOCA. Policy, Legal and Regulatory Assessment, Phase I Report, August 2002.
- BISNIS. Overview of the Georgian Agriculture Sector, Lotuashvili, January 2003.
- Georgian Agriculture and Trade Policy – Review, Liluashvil
- National Bank of Georgia, Banki, 1998 – 2004
- National Bank of Georgia, Bulletin of Monetary and Banking Statistics, 2001 – 2004
- Economic Development and Research Center, Website
- World Bank, Website
- IMF World Economic Outlook Database List, Website
- Selected data requested from the National Bank of Georgia Statistics Department
- Selected data requested from the State Department of Statistics.